



Saar Blueprints

Kanad Bagchi

Proposals For a Future
European State Bankruptcy Law



Programm für
lebenslanges
Lernen

02 / 2015 EN

About the author

The author is a research assistant at Europa-Institut, Saarland University and can be reached at (kanad.bagchi@gmail.com). The author is grateful to Prof. Dr. Werner Meng & Prof. Christos Gortos for their helpful comments and suggestions.

Preface

This publication is part of an e-paper series (Saar Blueprints), which was created as part of the Jean-Monnet-Saar activity of the Jean-Monnet Chair of Prof. Dr. Thomas Giegerich, LL.M. at the Europa-Institut of Saarland University, Germany. For more information and content visit <http://jean-monnet-saar.eu/>.

The opinions and analysis within these papers reflects the author's views and is not to be associated with Jean-Monnet-Saar or the respective employers or institutions that the authors work for.

Editor

Lehrstuhl Prof. Dr. Thomas Giegerich

Universität des Saarlandes

Postfach 15 11 50

66041 Saarbrücken

Germany

ISSN

2199-0050 (Saar Blueprints)

Citation

Bagchi, Kanad, Proposals for a future European State Bankruptcy Law, Saar Blueprints, 02/2015EN, online via: http://jean-monnet-saar.eu/?page_id=67

Abstract

The European Union's response to the sovereign debt crisis, although mixed and delayed, has been revolutionary and unparalleled at best. In the backdrop of discussions on a broader role for the private sector in such crisis situations, there has been a renewed call for an institutional mechanism to effectuate 'orderly debt restructurings'. In that connection, there have been various influential proposals calling for decisive Union action as against its silo-blinkered ad-hoc responses. This paper is a contribution to that debate and one, which unflinchingly calls for an institutional framework to deal with future sovereign restructurings in the Europe. In this regard, the author is inspired by and at the same time, goes beyond previous proposals on this issue. At the outset, the paper provides the reader with a background to the crisis and the lessons learnt from the same. It then explores the contours of a 'good bankruptcy law' for sovereigns and examines its need and relevance. Finally, the author unveils his own proposal for a new European Sovereign Debt Restructuring Framework, to be envisaged under theegis of the ESM Treaty. In an attempt to produce more clarity, the paper suggests certain model amendments to the ESM treaty and hopes that this will provide a basis for further debate.

A. INTRODUCTION

State bankruptcy is not a new phenomenon and nations have experienced it at different points in different eras.¹ Despite its antiquity, structures and processes to effectively deal with a state bankruptcy crisis have been rather piecemeal and national centric,² without any substantive regional or international rules on the subject, barring notable exceptions.³ The reason for this could possibly lie in the fact that sovereign insolvency is usually accompanied with a banking and a currency crisis,⁴ and therefore, a single approach to deal with multitude of issues is seen as rather intrusive into the affairs of a sovereign state. However, in view of the macroeconomic impact of sovereign insolvencies, there have been far reaching proposals on developing an international system of rules to efficiently deal with such contingencies, although, with limited success.⁵ In this paper, however, the author focuses on the debt crisis in Europe and more particularly in the euro zone. Considering the fact that Member States (hereinafter referred to as 'MS') of the European Union are more intrinsically linked with each other, through a sovereign mechanism, it will be instructive to assess its processes and methods of dealing with the present crisis. Since the crisis has unfolded in Europe far reaching steps have been taken at the Union level to safeguard the financial stability of the euro and to provide support to distressed MS.⁶ Further the European Central bank (hereinafter referred to as 'ECB') has had a key role to play in the entire episode.⁷ The purpose of this paper is to critically analyze the present instruments that have been put in

¹ See generally International Law Association (ed), Report of the 63rd Conference (Warsaw 1988) (International Law Association London 1988); *Gianviti F 'The International Monetary Fund and External Debt'* (1989) 215 RdC.205. p.86; *M. Reinhart Carmen & S. Rogoff Kenneth, 'Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten'*, IMF Working Paper, WP/13/266 (December, 2013). Can be accessed [here](#).

² *Jörn Axel Kämmerer, 'State Bankruptcy'*, Max Planck Encyclopaedia of Public International Law [MPEPIL] (2009). Can be accessed [here](#); *Rogoff, K. & J. Zettelmeyer, 'Early Ideas on Sovereign Bankruptcy Reorganization: A Survey'*, IMF Working Paper 02/57 (2000). Can be accessed [here](#).

³ *A Trotsenburg and A MacArthur, 'The HIPC Initiative: Delivering Debt Relief to Poor Countries'* (IMF World Bank Washington DC 1999). Can be accessed [here](#).

⁴ *Alexander Popov & Neeltje Van Horen, 'The impact of sovereign debt exposure on bank lending: Evidence from the European debt crisis'*, DNB Working Paper No.382 / June 2013. Can be accessed [here](#).

⁵ *K Rogoff & J Zettelmeyer, 'Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001'* (2002) IMF Staff Papers No. 49, p.470. Can be accessed [here](#).

⁶ *Zandstra Deborah, 'The European sovereign debt crisis and its evolving resolution'*, Capital Markets Law Journal, Vol. 6, No. 3. p 285. Can be accessed [here](#).

⁷ See generally *Roberto A. De Santis, 'The Euro Area Sovereign Debt Crisis, Safe Heaven, Credit Rating Agencies and the Spread of the Fever from Greece, Ireland and Portugal'*, ECB Working Paper Series, No. 1490/ February, 2012. Can be accessed [here](#); *Lucas Papademos, 'The role of the ECB in financial crisis management'* (conference on The cost of the financial crisis: Planning an exit strategy, organised by the Bank of Greece and the Hellenic Observatory at the London School of Economics and Political Science Athens, 27 May 2009). Can be accessed [here](#); *Paul De Grauwe, 'Only a more active ECB can solve the euro crisis'*, CEPS Policy Brief, No. 250 (August 2011). Can be accessed [here](#).

place in the European Union (hereinafter referred to as 'EU'/'Union'), including the much debated European Stability Mechanism (hereinafter referred to as 'ESM') facility.⁸ Deficiencies of the EU's strategy has been explored and related suggestions on adopting a more robust structure over and above the ESM facility have been proposed. In this regard, a comprehensive examination will be undertaken to assess the limits and boundaries of EU's legal competences as regards the above mentioned proposal. Further, various suggestions and proposals on containing Europe's crisis will be considered. The paper, however, does not explore the reasons behind the crisis, although, it discusses in detail some of the important issues as regards debt restructuring. The author trusts that in the face of international indecisiveness to initiate steps towards a unified approach in dealing with state bankruptcies, EU can provide an early example.

The paper is broadly divided into the following parts. Part II, provides an aerial survey of the European debt crisis and elucidates the role of the Union in an attempt to resolve the same. Part III collects the knowledge in the existing literature on finding solutions in the form of a crisis resolution mechanism. It also explores some of the most influential proposals aimed at attracting more decisive Union action for future crisis situations. Likewise, recounting the problems associated with debt restructurings, the author details some of the essential features that one has to consider before ideating on a future bankruptcy law. Finally, the last Part is devoted towards the constitution of the European Sovereign Debt Restructuring Framework, as the author would like to call it, and its ensuing mechanisms. Towards the end, the author proposes certain model draft treaty amendments to set the stage for further debate and discussion.

B. GENESIS OF THE CRISIS, EUROPEAN RESPONSE & ITS CHALLENGES – THE CASE OF GREECE

It is instructive to isolate and study the case of Greece, due to the fact that it was not only the starting point of the crisis, but still remains a focal point of the unfolding debate. As a first, the crisis in Europe and more particularly in Greece disheveled the idea that only emerging market countries were prone to such calamities.⁹ It also exposed the limitations and weaknesses of the Union's oversight on the budgetary and fiscal discipline in the EU, thereby calling into question the framework of the Economic and Monetary Union

⁸ Treaty Establishing the European Stability Mechanism of 2nd February 2012, consolidated version available [here](#).

⁹ For a comprehensive review of earlier instances of Emerging Market Debt Crisis refer to *K Rogoff & J Zettelmeyer, Supra* Note 5. See also Barnett, Barry C., *Sergio J. Galvis, & Ghislain Gouraige, Jr., 'On Third World Debt,'* Harvard International Law Journal, Vol. 25 (1984), p. 83–151.

(hereinafter referred to as ‘EMU’) itself.¹⁰ A direct attack was launched at the failure of the Growth and Stability pact, calling it “a fire code without a fire brigade.”¹¹ The crisis started unfolding soon after the change of the old government and the public acknowledgment of Mr. George Papandreou that Greece had been misrepresenting and misreporting on its public debt figures for years.¹² That was a huge loss of confidence for the market¹³ and since then, there was no stopping the downfall. The problem was accentuated by the fact that the debt crisis was swiftly seeping into the banking sector which caused MS to immediately rush to save their banks.¹⁴ The UK House of Lords report on the crisis dubbed it a “*syndrome of multiple interdependent crises*” referring to a solvency, liquidity and banking crisis.¹⁵ While there are studies¹⁶ on the interrelationship of a banking and sovereign debt crisis, this paper does not address that issue.

I. The Bailout Package

Towards mid-May, 2010 the crisis reached unmanageable levels¹⁷ and contagion started spreading to other MS, mostly the peripheral ones.¹⁸ The difference in bond spreads only increased, as the markets hit the panic button on the assumption that the worsening situation of the indebted MS would not be contained.¹⁹ It was presumed that they would most certainly not receive any assistance from other MS or the Union. There was a fear that the Euro would break apart. However, it turned out to be quite the contrary. At the instance of

¹⁰ See Lorenzo Bini Smaghi, ‘Challenges for the Euro Area, and the World Economy’, Group of the Thirty, Rabat, 28 May 2010. Can be accessed [here](#); ‘Is this really the end?’, The Economist, Nov 26th 2011, [here](#); ‘The euro’s inevitable failure will be horrendous for all of us,’ The Telegraph, May 20th 2014, [here](#); ‘The Failure of the Euro,’ Foreign Affairs, January-February 2012, [here](#); ‘Has ‘Europe’ Failed?’, The New York Times, August 26th 2012, [here](#).

¹¹ De Grauwe, ‘Fighting the wrong enemy’, VOX, 19th May 2010. Can be accessed [here](#).

¹² Louise Story, Landon Thomas, Jr. & Nelson D. Schwartz, ‘Wall St. Helped to Mask Debt Fueling Europe’s Crisis’, N.Y. TIMES, Feb. 14, 2010; see also Charles Forelle & Stephen Fidler, ‘Europe’s Original Sin: National Leaders Ignored Greece’s Soaring Debt for Years’, WALLST. J., Mar. 3, 2010.

¹³ See “Moody’s downgrades Greece to Ba1 from A3”, Global Credit Research, 14 Jun 2010. Can be accessed [here](#); ‘Fitch downgrades Greek debt to BBB-minus,’ The Independent, May 20th 2010. Can be accessed [here](#).

¹⁴ See generally A. Petrovic & R. Tutsch, ‘National Rescue Measures in Response to the Current Financial Crisis,’ (European Central Bank Legal Working Paper Series No. 8, July 2009). Can be accessed [here](#).

¹⁵ UK House of Lords European Union Committee, The Euro Area Crisis (25th Report of Session 2010-2012), ¶11. Can be accessed [here](#).

¹⁶ See Carmen M. Reinhart & Kenneth S. Rogoff, *Supra* Note 1; Adrian Blundell-Wignall & Patrick Slovik, ‘A Market Perspective on the European Sovereign Debt and Banking Crisis,’ (OECD Journal: Financial Market Trends Volume 2010 – Issue 2). Can be accessed [here](#).

¹⁷ The Sovereign Debt to GDP ratio reached a staggering 148%. See data from Eurostat, available [here](#).

¹⁸ Victor Constancio, ‘Contagion and the European debt crisis,’ Banque de France (Financial Stability Review No. 16, April 2012). Can be accessed [here](#).

¹⁹ Francois Gianviti, Anne o. Krueger, Jean Pisani-Ferry, Andre Sapir & Jurgen Von Hagen, ‘A European mechanism for sovereign debt crisis resolution: a proposal,’ (Bruegel Blueprint Series, Vol. 10, 2010). Can be accessed [here](#).

Greece, the Union and the Euro Area MS resolved to “*take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole.*”²⁰ In pursuance of that, a three-year rescue package, consisting of bilateral loans of 80 billion euros along with an additional 30 billion euros from the IMF was agreed upon. Further the European Financial Stability Facility (hereinafter referred to as ‘EFSF’) and the Securities Market Purchase Program of the ECB were established to foster confidence in the market.²¹ Although the above measures were able to calm the markets for a short duration, the IMF was not very positive in its annual report on Greece.²² Soon it was realized that along with official sector lending, private sector involvement would be necessary, considering the fact that Greece will not be able to return to the debt market within the time that was originally envisaged. The next section highlights the key features of this second package of measures which was a combination of additional loan from the official sector coupled with a debt restructuring plan.

II. The Debt Restructuring Plan – Its Features & Challenges

The initial IIF financing offer consisted of a modest haircut and extra financing. A total of 179 billion euros were to be dispersed from mid-2011 to mid-2014 along with a bond exchange involving an NPV loss of 21%.²³ However, it was soon realized that, the offer would fall short of the expected results.²⁴ In the IMF’s opinion,²⁵ the IIF financing offer would not suffice and that Greece would need much more commitment from the private sector. Further, it would also take a longer duration for it to regain its capacity to borrow from the sovereign debt markets. In this backdrop, the restructuring plan was historic in all its proportions. It was going to create a record in terms of both, the magnitude of the debt restructured and the loss to creditors as a consequence.²⁶ It called for a 53.5% waiver on the principal amount of 135 bond series, along with the exchange of new low-coupon Greek bonds with maturities of 11 to 30 years for the remaining 31.5%. A sweetener was added by providing two-year EFSF notes for the rest 15% of the NPV. Although the range has been disputed,²⁷ the total loss to

²⁰ Press Release, STATEMENT BY THE HEADS OF STATE AND GOVERNMENT OF THE EURO AREA, (Brussels, March 25th 2010). Can be accessed [here](#).

²¹ Jeromin Zettelmeyer, Christoph Trebesch, & Mitu Gulati, ‘The Greek Debt Restructuring: An Autopsy’, (PIIE Working Paper series, WP 13 – 8 (August 2013)). (Hereinafter referred to as ‘Jeromin et al’). Can be accessed [here](#).

²² ‘Greece: Fourth Review Under the Stand-By Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria,’ IMF Country Report No. 11/175 (2011). Can be accessed [here](#).

²³ IIF, ‘IIF Financing Offer’, July 21st 2011. Can be accessed [here](#).

²⁴ Landon Thomas Jr, ‘European Banks Face Huge Losses from Greek Bonds’, New York Times, October 4th 2011. Can be accessed [here](#).

²⁵ IMF, ‘Greece: Debt Sustainability Analysis’, October 21st 2011. Can be accessed [here](#).

²⁶ Jeromin, *supra* Note 21.

²⁷ *Ibid*.

investors was calculated to be around 70% and 75% of the NPV. Along with it, a financing proposal to the tune of 130 billion was arranged from the EU and IMF. The total debt of the government held by private sector was reduced to 3.1% of the total 205.5 billion euros.²⁸

Despite repeated warnings from the ECB,²⁹ regarding Private Sector Involvement, the plan to require more participation from the private sector was taken. One of the major challenges that were faced in the context of the Greek debt restructuring, the holdout problem, was addressed through far reaching innovative mechanisms. The use of Collective Action Clauses (CACs) to increase creditor participation, by retroactively amending the Greek law was seen as a clever move in the face of impending crisis.³⁰ The concern regarding moral hazard was let go of, because the deal was thought to be beneficial, individually for the other countries and collectively for the currency union.³¹ However, despite the novelties, the debt restructuring plan can be best described as ad-hoc and has created a lot of unwise precedents. Although its inevitability has been granted, the plan has called for some criticism. The most common of them are that the restructuring was too late, that it exposed the European taxpayers to immense risks and that the treatment meted out to the holdout creditors was unnecessarily generous.³² It is therefore instructive to see if there are lessons that can be drawn from the above restructuring exercise and also analyze whether there is an imminent need for a more permanent and institutional restructuring mechanism under EU law.

²⁸ Press Release, Ministry of Finance, Hellenic Republic, April 25th 2012. Can be accessed [here](#).

²⁹ See 'ECB warns against private role in bail-outs', Financial Times, 13th October, [here](#); Sylvester Eijffinger & Lex Hoogduin, 'The ECB in (the) crisis', DSF Policy Paper Series, No. 22 (June 2012). Can be accessed [here](#); José Luis Malo de Molina, 'The European Central bank's Response to the Crisis', Economic Bulletin (July, 2013). p. 37. Can be accessed [here](#).

³⁰ Melissa A. Boudreau, 'Restructuring Sovereign Debt Under Local Law: Are Retrofit Collective Action Clauses Expropriatory?' Harvard Business Law Review online. Can be accessed [here](#).

³¹ See 'Sovereign Debt Restructurings – Recent Developments and Implications for the Funds Legal and Policy Framework', IMF 26th April, 2013. Can be accessed [here](#); Silvia Ardagna and Francesco Caselli, 'The Political Economy of the Greek Debt Crisis: A Tale of Two Bailouts', Centre for Economic Performance Special Paper No. 25, LSC (2012), p. 9-10. Can be accessed [here](#).

³² Jeromin, *supra* Note 21.

C. PROPOSAL FOR A ROBUST EUROPEAN STATE BANKRUPTCY MECHANISM

The author's proposal for an EU framework mechanism for Sovereign bankruptcies is a contribution to the already raging debate in this area. It seeks to go beyond existing proposals currently under consideration and provides for a more comprehensive approach to the issue of Sovereign bankruptcies in the context of the European Union. It argues that there is an impending need for a permanent and robust mechanism to deal with 'orderly restructurings' in Europe. In the process it also seeks to analyze various legal and political compulsions that may ensue in the run up to the mechanism. It highlights the specific roles of the Union institutions, in the discharge of their functions under the mechanism. Keeping in mind parallel developments in the realm of public international law on the subject, the author has also taken care to examine the possibility of a potential overlap and its likely solutions. The focus of the author is not to extrapolate an optimal restructuring plan, but to provide a legal framework within which a restructuring plan, as agreed between the sovereign and its creditors, can be operated.

I. THE NEED AND RELEVANCE

The debt crisis reached threatening levels, primarily because of the loss of investor confidence in sovereign bonds. Hurried governments on the brink of default, rushed to publicly declare that they will support their banks, as a definitive portion of the debts were held by them.³³ There was no contingency plan of the EU to respond to the crisis. The approach till now was ex-ante surveillance and budgetary rules, which failed miserably to induce fiscal discipline in MS. It was thought that "...*The Stability and Growth Pact would do the trick – just make sure that countries abide by the rules. If they do so, i.e. if they are always well-behaved, there is no need for an automatic insurance mechanism...*"³⁴ While bailouts have been in vogue to rescue failing States, the EU is legally constrained to take such action. The "no-bail out" clause in the treaty is an explicit bar on the Union and the MS to "*be liable for or assume the commitments of central governments...*"³⁵ Further, even the ECB is prohibited from monetary financing of the budget of a MS.³⁶ Considering the fact that

³³ Fernando M. Martin & Christopher J. Waller, 'Sovereign Debt: A Modern Greek Tragedy', Federal Reserve Bank of St. Louis Review (September/October 2012). p. 321. Can be accessed [here](#).

³⁴ De Grauwe, *Supra* Note 11.

³⁵ Art. 125, Treaty on the Functioning of European Union (hereinafter referred to as 'TFEU'); Jean-Victor Louis, 'Guest Editorial: The no-bailout clause and rescue packages' (2010) 47 Common Market Law Review, Issue 4, pp. 971–986. Can be accessed [here](#).

³⁶ Art. 123, TFEU; Carlo Panico & Francesco Purificato, 'The Debt Crisis and the European Central Bank's Role of Lender of Last Resort', (PERI Working Paper Series, No. 306. (January, 2013)). Can be accessed [here](#).

the euro area countries do not have monetary or exchange rate flexibility to absorb asymmetric shocks, it is rather imperative that a mechanism of transfer of funds exists in order to neutralize the asymmetry.³⁷ Although, the ESM treaty³⁸ has gone a long way in addressing this issue, it still does not address a situation where the debt level of a MS is truly unsustainable. Further, it leaves the question of debt restructuring unanswered. Hence the response at the EU level has been ad-hoc, as was seen in the case of Greece, which caused considerable uncertainty in the minds of the bondholders. They became increasingly skeptical about the willingness and ability of Greece to pay back its debts, unnerved by behavior of the other bondholders (holdout creditors) and indeterminate regarding the extent of financial assistance from other MS and the Union.³⁹ In such circumstances, an 'orderly debt restructuring' plan through a combination of new funding and restructuring of outstanding debt, with strict conditions,⁴⁰ can infuse much needed credibility and predictability in the system. Further, it will also send out a strong message of "no bail out" to the MS for their incessant borrowings and to the creditors for their risky investment, thereby addressing the moral hazard problem.⁴¹

II. RECOUNTING THE PROBLEMS ASSOCIATED WITH DEBT RESTRUCTURINGS

In the hindsight, evidence in emerging markets have shown that restructuring of essentially private debt is rather long delayed, sluggish, results in huge losses to creditors, attaches considerable cost to the process and finally may not be effective to return the country to levels of debt sustainability.⁴² Although there have been various proposals⁴³ demonstrating the most optimal debt restructuring plan, this paper does not address this issue. The author considers the above problems to be rather inevitable in any process of debt restructuring

³⁷ *Ashoka Mody*, 'Sovereign Debt and its Restructuring Framework in the Euro Area', Bruegel Working Paper No 05 (2013). Can be accessed [here](#).

³⁸ It was authorized by Art. 136 (3) TFEU, added by European Council Decision 2011/199/EU of 25th march 2011 (OJ L91, p.1).

³⁹ *Francois Gianviti et al*, *supra* Note 19.

⁴⁰ *David A. Skeel, Jr. & Patric Bolton*, 'Inside the Black Box: How Should a sovereign Bankruptcy Framework be Structured', *Emory Law Journal*, Vol. 53. p. 764 (2004).

⁴¹ *Régis Breton, Caroline Pinto & Pierre-François Weber*, 'Banks, moral hazard, and public debts' (Financial Stability Review No. 16, April 2012). Can be accessed [here](#); *Kirsten H. Heppke-Falk & Guntram B. Wolff*, 'Moral hazard and bail-out in fiscal federations: evidence for the German Länder', (Deutsche Bundesbank, Discussion Paper Series 1: Economic Studies No. 7, 2007). Can be accessed [here](#).

⁴² *Markl. J. Wright*, 'Sovereign Debt Restructuring: Problems and Prospects', *Harvard Business Law Review*, Vol. 2. p. 154 (2012). Can be accessed [here](#).

⁴³ *Guillermo Calvo*, 'On the Time Consistency of Optimal Policy in a Monetary Economy', 46 *ECONOMETRICA* 1411 (1978); See generally *Finn E. Kydland & Edward C. Prescott*, 'Rules Rather Than Discretion: The Inconsistency of Optimal Plans', 85 *J. POL. ECON.* 473, 486–87 (1977). Can be accessed [here](#); *Michael P. Dooley*, 'International Financial Architecture and Strategic Default: Can Output Losses Following International Financial Crises be Avoided?', 53 *CARNEGIE-ROCHESTERCONF. SERIES ONPUB. POL'*Y361, 371–74 (2000).

and hence limits his analysis to two issues, which can essentially either make or break a possible restructuring. Collective action problems and availability of sustainable funding during the process of restructuring are probably the most crucial to any successful attempt at restructuring.

1. Collective Action Problems

Collective action problems (hereinafter referred to as 'CAPs') essentially occur at two levels. First, when a possible default of a country becomes rather apparent, creditors 'rush to exit' their investments or sell their bonds in anticipation of a higher return.⁴⁴ This depresses the market for the bonds and the prices fall dramatically, which leads to further complications. Add to that, once a debt restructuring mechanism has been put into place, a minority group of creditors may try and stall the process, in anticipation of being fully paid by the sovereign. Such creditors take advantage of the fact that any debt restructuring process requires the consent of all creditors. This is known as the 'holdout problem'.⁴⁵ This can severely hamper bilateral negotiations between the majority creditors and the sovereign. In fact, it has been observed that, willing creditors often lose their inclination for further negotiations due to the obstructionist methods of the holdout creditors.⁴⁶ The problem is further compounded by the fact that courts have, in various instances, approved a holdout right of the creditor in question.⁴⁷ Therefore, there is also a phenomenon of 'rush to the courts',⁴⁸ which is experienced.

2. Funding Problems

It is only when a sovereign is beset with financial difficulties and is no longer able to garner further funding to service its debts, it resorts to debt restructuring. In such situations, there are invariably huge costs associated with a debt restructuring process.⁴⁹ As a first, a country may be facing an acute banking crisis as result of its exposure to government debt. Due to the loss of claim to bondholders, there can be overall downsizing in consumption and

⁴⁴ Joanna Dreger, 'Why Is Sovereign Debt Restructuring a Challenge? The Case of Greece', Bruges European Economic Policy Briefings No. 24 (2012). Can be accessed [here](#). See also FRANÇOIS GIANVITI et al, *Supra* Note 19.

⁴⁵ Steven L. Schwarcz, 'Sovereign Debt Restructuring Options: An Analytical Comparison', Harvard Business Law review, Vol. 2.p. 96. (2012). Can be accessed [here](#); Lee C. Buchheit & G. Mitu Gulati, 'Exit Consents in Sovereign Bond Exchanges', 48 UCLA L. REV.59, 60 n.2 (2000).

⁴⁶ John C. Coffee, Jr. & William A. Klein, 'Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations', 58 U. CHI. L. REV.1207, 1223 (1991).

⁴⁷ *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985); *Elliott Associates v. Banco de la Nacion*, 194 F.3d 363 (2d Cir. 1999).

⁴⁸ Miller Marcus, 'Sovereign Debt Restructuring: New Articles, New Contracts—or No Change?', International Economics Policy Brief No. PB02-3 (2002). Can be accessed [here](#).

⁴⁹ Joanna Dreger, *Supra* Note 44.

spending in the economy.⁵⁰ Under such circumstances, creditors are wary to lend extra funds to the government unless they are conferred priority status.⁵¹ Therefore, it becomes essential to infuse fresh funds into the government at favorable rates so as not to disrupt its core governmental functions.⁵² At the same time, it is imperative to preserve the commitment and support of the existing creditors.

III. ESSENTIALS OF A GOOD EUROPEAN BANKRUPTCY LAW

In the preceding section we have seen the different problems that may ail the debt restructuring process. Therefore, it is the opinion of the author that, any good bankruptcy law should have certain mechanisms to respond to the above mentioned issues. The next section brings together some solutions.

Any proposed bankruptcy law has to address the issues related to collective action problems and sustained funding during the process of debt restructuring. Although there have been various proposals put forth to deal with such problems like providing for acceleration clauses and trustee and bond holder committee clauses in debt instruments,⁵³ the author regards the use of collective action clauses (hereinafter referred to as 'CAC'), as showing the most definitive results. By the use of CAC, in individual financing agreements, a super majority of creditors can bind the minority creditors as regards the restructuring terms.⁵⁴ Once the minority 'holdout' creditors are tied to the financing terms of the bond issue, the debt restructuring plan can proceed unhindered. Further, CAC also ensures that final repayment is shared equally among all bondholders.⁵⁵ Such clauses have traditionally existed under the English law and of lately have found their way into the New York law.⁵⁶ The disadvantage with CAC is that they apply to only individual bond classes and do not employ aggregate voting across all classes of issue. Therefore, CAC bind only the creditors or bondholders within the same issue and do not address the problem of holdout in the other classes or

⁵⁰ *Adrian Blundell-Wignall & Patrick Slovik, 'Solving the Financial and Sovereign Debt Crisis in Europe,'* (OECD Journal: Financial Market Trends Volume 2011 – Issue 2). Can be accessed [here](#).

⁵¹ *Patrick Bolton & David A. Skeel, JR., 'Redesigning the International Lender of Last Resort',* 6 CHI. J. INT'LL. 177, 186–87 (2005).

⁵² *Steven L. Schwarcz, "'Idiot's Guide" To Sovereign Debt Restructuring',* Emory Law Journal, Vol. 53. p. 1190 (2004). Can be accessed [here](#).

⁵³ See generally *Michael Bradley & Mitu Gulati, 'Collective Action Clauses for the Eurozone: An Empirical Analysis',* third draft, May 7th 2012. Can be accessed [here](#).

⁵⁴ *Stephen J. Choi, Mitu Gulati, and Eric A. Posner, 'The Evolution of Contractual Terms in Sovereign Bonds',* Journal of Legal Analysis, (2012): Vol. 4, No. 1.p 133.

⁵⁵ *Ibid.*

⁵⁶ *Mark Gugiatti & Anthony Richards, 'The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers',* 35 GEO. J. INT'LL. 815, 815–17 (2004).

issues.⁵⁷ In the contractual realm, within which CAC operate and considering the multitude and complexity of debt instruments that are issued by a sovereign, it has been suggested that CAC, despite their uniqueness are “*an exercise in futility*”.⁵⁸ Therefore, it is submitted that collective action problems require a response, which goes far beyond the domain of pure contractual arrangements. In this regard, the author proposes an institutional framework whereby all claims can be brought under one roof and within the operation of a regulated restructuring process.

A good bankruptcy law will also have to address the concerns regarding stop-gap funding once a debt restructuring has commenced. In this regard, it is rather imperative that a priority status is granted to the loans provided to the sovereign debtor at the time of the restructuring process. In this manner, creditors can be infused with a sense of confidence and they will be more willing to lend in. However, considering the mechanism already in place in the European Union, the issue of additional funding during the stage of restructuring is not a big concern. The above concerns will be addressed below.

IV. PROPOSALS SO FAR

Since the onset of the Greek sovereign debt crisis there have been various far-reaching proposals on a mechanism to effectively deal with such situations in future. They all highlight the immediacy and urgency of the measures in the context of a bigger contagion in the EU region. Some of the suggestions deal with stricter *ex ante* supervision of both MS and banks, while others specifically deal with sovereign debt restructuring of euro area members.⁵⁹ The author believes that a brief mention of the proposals is instructive to put his own model into perspective. They can be divided into two distinct categories. One set of proposals urge for a more institutional approach and hence I have categorized them under “Proposals on an Institutional Mechanism”, whereas others I have categorized simply as “Other Proposals”, which is of course not to belittle their importance.

⁵⁷ W. Mark C. Weidemaier & Mitu Gulati, ‘A People’s History of Collective Action Clauses’, Virginia Journal of International Law, Vol. 54:1, p. 52. Can be accessed [here](#).

⁵⁸ See Hal S. Scott, ‘A Bankruptcy Procedure for Sovereign Debtors?’, 37 INT’LL. 103, 108–09 (2003). Can be accessed [here](#).

⁵⁹ Zandstra Deborah, *supra* Note 6.

1. Proposals For An Institutional Mechanism

a) Creation of a European Monetary Fund

Although there have been many proposals on the creation of a European Monetary Fund⁶⁰ (hereinafter referred to as 'EMF') the most detailed and comprehensive one has been put forth by Prof. Daniel Gros and Thomas Mayer.⁶¹ Their central argument is to create a permanent body to deal with 'orderly defaults' as matter of last resort. The EMF, as they call it, would provide conditional funding on the basis of an adjustment program to MS in need. Further, to structure an 'orderly default', it envisages a debt exchange program to creditors with a suitable haircut. They propose to deal with the issue of moral hazard primarily through the financing mechanism of the EMF. The countries with excessive deficits and debt levels as measured by the Maastricht criteria⁶² would contribute a higher percentage to the fund as opposed to the others. By this mechanism they hope to effectively minimize "*disruption caused by the failure of one of its Member States...*"⁶³ and respond efficiently to a crisis situation.

b) Creation of a European Crisis Resolution Mechanism

Prof Gianviti and others,⁶⁴ propose a statutory European Sovereign Crisis Resolution Mechanism (hereinafter referred to as 'SCRM'), much like the SDRM proposal which had been mooted by the IMF. At the outset the proposal outlines the two pillars on which it is based. They identify the need for a proper procedure to coordinate and collate negotiations between the creditors and sovereign debtor, resulting in an enforceable agreement on a possible debt restructuring plan. This process would be initiated only after an assessment that the debt of the MS is truly unsustainable. This task of initiating and coordinating the debtor creditor negotiations and any resulting disputes, are to be handled by the Court of Justice of the European Union in its mission to "*ensure that the law is observed*". Further, the European Commission would be tasked with the assessment of determining the level of debt unsustainability. Finally, the then European Financial Stability Framework would take care of

⁶⁰ See Giancarlo Corsetti and Harold James, 'Why Europe needs its own IMF', Financial times, March 8th 2010., [here](#); Miguel Boyer, 'Europe needs its own IMF', The Guardian, March 29th 2011. Can be accessed [here](#).

⁶¹ Daniel Gros and Thomas Mayer, 'How to deal with sovereign default in Europe: Create the European Monetary Fund now!', CEPS policy Brief No. 202, February 2010, updated May 17th 2010. Can be accessed [here](#).

⁶² Protocol (No. 12) on the Excessive Deficit Procedure, TFEU.

⁶³ *Ibid.*

⁶⁴ Francois Gianviti et al, *supra* Note 19.

the immediate funding needs. However, in this regard they provide a caveat that to undertake the above function the EFSF needs to be made permanent.⁶⁵ The above they believe, would lay down and display a very clear resolve of the EU to effectively deal with crisis situations in the face of abject uncertainty.

2. Other Proposals

Prof. Dr. Weber in this proposal⁶⁶ argues for the inclusion of a trigger clause in the bond agreements, which would automatically postpone the maturity of the relevant bonds for three years. The trigger would be initiated at the time when the ESM has agreed to extend funding to a distressed MS. The debtor country will have the opportunity to implement the macroeconomic adjustment plan within this three year time period. Weber suggests that there should be no change in the other terms and conditions of the bond, except as regards its maturity. He perceives a whole range of benefits in the nature of reduced borrowing cost for the troubled sovereign and better financial market stability. In the backdrop of the debate regarding an appropriate involvement of the private sector, Weber argues that by this mechanism liability would not be passed to the taxpayer and will instead remain with the investors.⁶⁷

Other proposals have been targeted at bond market stabilization by the use of a common euro area bond.⁶⁸ The main advantage of using a common euro bond would be to eliminate speculative behavior in the euro area which would help in stabilizing the market, in relation to bonds. However, there has not been much headway regarding this proposal.

D. A SUBSTANTIVE PROPOSAL FOR A FUTURE EUROPEAN BANKRUPTCY LAW

The author in the discussions above has highlighted first, the need and relevance of an EU framework to deal with sovereign debt crisis in Europe. Next, the issues that are to be addressed in any debt restructuring process have been drawn out; wherein collective action problems and stop gap funding at the time of the restructuring, were marked as the most

⁶⁵ *Ibid.*

⁶⁶ A. Weber, Jens Ulbrich & Karsten Wendorff, 'Safeguarding financial market stability, strengthening investor responsibility, protecting taxpayers: A proposal to reinforce the European Stability Mechanism through supplementary bond issuance terms', *Frankfurter Allgemeine Zeitung*, March 3rd 2011. Can be accessed [here](#).

⁶⁷ *Ibid.*

⁶⁸ See 'Co-ordinated Public Debt Issuance in the Euro Area', Report of the Giovannini Group, November 8th 2000, [here](#); , Jean-Claude Juncker & Giulio Tremonti, 'E-bonds would end the crisis' *Financial Times*, December 5th 2010, [here](#); Mario Monti, 'A new strategy for the single market', Mario Monti Report, May 9th 2010. Can be accessed [here](#).

crucial ones. In the light of the relevance and importance of the matter, various proposals to effectively deal with a future crisis situation have been considered. This part of the paper draws out a substantive proposal to address the need for a state bankruptcy law for the MS of the European Union. This is certainly not a novel proposition, but rather builds on the existing ones. The idea is to go beyond a mere framework on a model state bankruptcy law and to detail out the specifics of how the law should essentially look like. In this regard, the author proposes the creation of a European Sovereign Debt Restructuring Framework (hereinafter referred to as 'ESDRF') consisting of definitive rules and regulations for an 'orderly restructuring'. Under this framework, a European Sovereign Debt Restructuring Council (hereinafter referred to as 'ESDRC') will be formed to resolve the disputes between the parties. Although, there have been suggestions that the new crisis resolution mechanism should be constituted under a new treaty,⁶⁹ the ESDRF as proposed by the author, requires an amendment to the already existing ESM treaty. The ESDRF as envisaged could effectively use the institutional mechanisms of the ESM in carrying out its functions. Next, the author explains the arrangements and mechanisms of the proposed amendments and also details the respective roles and responsibilities of the Union institutions. The ESDRC, its role, functions and limitations is examined and in this connection the author draws heavily from the SDRM proposal of the IMF. Finally, an attempt has been made to provide a draft set of treaty amendments.

I. EUROPEAN SOVEREIGN DEBT RESTRUCTURING FRAMEWORK & ITS KEY FEATURES

For any debt restructuring framework to produce results it needs to be based on certain core essential doctrines. First, it is crucial to point out that, the ESDRF will be activated only after an assessment of debt unsustainability has been made by the European Commission in liaison with the ECB.⁷⁰ Taking into consideration the vast experience and expertise of the IMF in relation to sovereign debt restructurings, it is suggested that assessment of the debt sustainability of a MS is conducted in consultation with the IMF. The ESDRF and the ESDRC in particular will interfere only with an objective to facilitate an agreement between the parties. As was pointed out by Anne Krueger, debt restructuring should take place in the "shadow of the law".⁷¹ Considering the advantages of early debtor – creditor negotiations,⁷²

⁶⁹ Francois Gianviti et al, *supra* Note 19.

⁷⁰ Art. 13, ESM Treaty, *supra* Note 8.

⁷¹ Anne Krueger, 'International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring', American Enterprise Institute, Washington DC, November 26th 2001. Can be accessed [here](#).

the framework mandates the constitution of creditor committees with appropriate representation, which will induce more transparency in the restructuring process. The ESDRC will not substitute its own judgment for the agreement reached between the parties. Under the framework, claims against creditor nations or international institutions will not be restructured. The author believes that the London club and the Paris club would be the proper forum for such claims. Further, the framework contains a mechanism to place a moratorium on all payments due to creditors. It also addresses the need to provide stop gap funding to a distressed MS.

II. CONSTITUTION OF THE ESDRC AND ITS FUNCTIONS

The ESDRC essentially will be a dispute resolution body tasked occasionally with administrative functions. It shall be an independent body and would have exclusive jurisdiction over the ESDRC proceedings and matters related thereto. It will consist of one person with a high level of expertise in the field of sovereign debt restructurings, from each of the MS of the ESM, approved by the Board of Governors of the ESM (hereinafter referred to as '*BOG*'). Upon the activation of the ESDRF, the Managing Director of the ESM (hereinafter referred to as '*MD*') on the advice of the European Central Bank and the European Commission (hereinafter referred to as '*ECB*' & '*EC*' respectively) will choose from amongst the persons confirmed above, to serve in the ESDRC panel. The ESDRC panel would adjudicate on disputes relating to the determination of the amount of claims involved, the aggregate voting process for the adoption of a restructuring plan and questions as regards the proper representation of the creditors in the creditor committees. To ensure that no party suffers a disadvantage, the ESDRC once constituted will adopt its own procedure and in this regard will be guided by the UNIDROIT Principles of Transnational Civil Procedure. The decision of the SDRC will be final and binding on the parties.

III. MORATORIUM ON CREDITOR PAYMENTS AND DEBTOR IMMUNITY FROM ENFORCEMENT

Although, the IMF has distanced itself from suggesting an immediate moratorium on all creditor rights,⁷² the author contends to the contrary. It is to be noted that an immediate moratorium on all creditor rights including the right to enforcement of the debtor's assets will only aid the process of the restructuring. In this manner, the incentives for the 'holdout'

⁷² 'The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations', Prepared by the Legal and Policy Development and Review Departments, IMF, November 27th 2002. Can be accessed [here](#).

⁷³ 'The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations', IMF working paper, November 27th 2002. p. 39. Can be accessed [here](#).

creditors will be substantially reduced and will prevent a 'rush to the courts'. However, upon the commencement of the negotiations, a creditor may petition the ESDRC for lifting the stay on enforcement or payment of outstanding dues, on the basis that the debtor has not been negotiating in good faith.

IV. CONSTITUTION OF THE CREDITOR COMMITTEE

Early debtor-creditor coordination will enable the formulation of a quicker restructuring plan and would reduce the uncertainty in the markets. Therefore, it is proposed that soon after the sovereign debtor has made all the necessary disclosures regarding its indebtedness, the MD shall call for the constitution of a committee of creditors affected, with proportionate representation. Any dispute as regards the representative character of the committee will be referred to the ESDRC. The committee along with the sovereign debtor will undertake negotiations so as to arrive at a restructuring plan. To address the concerns that debtors are usually reluctant to participate in a coordination meeting,⁷⁴ a pertinent assessment of the good faith negotiations of the debtor will be undertaken to finally decide on the amount of the funds to be extended under the ESM.

V. VOTING THRESHOLD UNDER THE ESDRF

In the case of restructurings involving bond issues held by private parties, invariably, the sheer size and number of the bondholders makes the negotiation process rather challenging.⁷⁵ Voting patterns have to reflect the concerns of a debtor, having to satisfy each and every bondholder, and the necessary adverse consequences of that process on debt restructuring. In this regard, the recent decision of the euro area MS to embrace the use of CAC to simplify the debt restructuring process goes a long way in addressing the hold out problem.⁷⁶ Although there is some literature suggesting that the inclusion of CAC increase the borrowing costs of the sovereign debtor, there is no real evidence to establish that claim.⁷⁷ However, as noted above, CAC suffer from the limitation that super-majority voting is restricted only to that class of bond issues, in which it is provided. Therefore, a

⁷⁴ *Ibid*, p. 43.

⁷⁵ Mark L. J. Wright, 'Restructuring Sovereign Debts with Private Sector Creditors: Theory and Practice', University of California, Los Angeles, and National Bureau of Economic Research. June 2nd 2010. Can be accessed [here](#).

⁷⁶ Press Release, STATEMENT BY EURO GROUP (Brussels, November 28th, 2010, [here](#); European Council Conclusion, EUCO 10/1/11 REV 1, Brussels April 20th 2011. p, 31. Can be accessed [here](#).

⁷⁷ See Barry Eichengreen & Ashoka Mody, 'Do Collective Action Clauses Raise Borrowing Costs?', 114 ECON. J. p. 247 (2004); Torbjorn Becker, Anthony Richards & Yunyong Thaicharoen, 'Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?', 61 J. INT'LECON, p. 127 (2003); Anthony Richards & Mark Gugiatti, 'Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets', 6 INT'LFIN. p. 415 (2003).

restructuring process may nonetheless be stalled by obstructionist bondholders in other classes of bond issues. To remedy this defect, it is the author's suggestion to include aggregation clauses within the debt instruments whereby financial terms of more than one class of bonds can be modified by an aggregate voting across all debt instruments.⁷⁸ The latest draft of the Sub-committee on Sovereign Debt Markets provides for a cross-series voting requirements in line with calls for aggregated voting. It provides for an aggregate voting percentage of not less than 75% of the total principle amount of the debt outstanding along with a 66% of votes in each individual bond series.⁷⁹ The author is in full agreement with the above thresholds and suggests the inclusion of the same while voting on matter under the ESDRF.

VI. APPROVAL OF THE RESTRUCTURING PLAN AND IMMEDIATE FINANCING

Once a restructuring plan has been agreed upon, it shall be sent to the MD, BOG and the ESDRC for their approval. The ESDRC, upon receiving the plan will verify the application of voting thresholds and also determine whether to lift the moratorium or amend its terms in accordance with the restructuring plan. At this stage, the ESDRC will be dissolved and become *functus officio*. On approval, the Board of Governors will entrust the ECB and EC to draw out a plan for immediate funding, having regard to the amount necessary to support core governmental functions and services.

⁷⁸ Nouriel Roubini & Brad Setser, 'The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode', Draft, April 2004. Can be accessed [here](#).

⁷⁹ (EFC) Sub-Committee on EU Sovereign Debt Markets, Common terms of Reference, February 17th 2012. Can be accessed [here](#).

E. CONCLUSION

The debt crisis in Europe has given rise to unique problems and along with those newer solutions. What started in Greece, slowly spread to other MS, affecting them in varying ways. The whole edifice of the Economic and Monetary Union was disheveled, and European values and institutions were called into questions.⁸⁰ EU, as we have seen responded valiantly, but not decisively. Far reaching steps were initiated to preserve the financial stability of the Euro and of the MS for which even the treaties were pushed to their constitutional limits.⁸¹ The purpose of this paper was to study the mechanisms and processes that were employed by the Union to deal with the present crisis. In this regard, the author briefly discussed the turning points of the unfolding crisis and highlighted the European response to the same. In order to better appreciate the call for more private sector involvement, the Greek debt restructuring package was studied. In the process, it was discovered that Europe as it stands today lacks an institutional mechanism to deal with an 'orderly debt restructuring', which was one of the main reasons for the uncertainty and vulnerability of the markets in the backdrop of the Greek crisis. The absence of an institutional framework sent out mixed signals to market participants regarding the resolve of Europe to preserve its Union. Further, because of the lack of a formal process of debt restructuring, there was considerable delay in the entire process. As we have seen, the ESM, although a step in the right direction, is silent in the event of public debt of a MS being declared unsustainable. Therefore, it is the submission of the author that there is an imminent need for rule based institutional framework to deal with such crisis situations in future, in a much more systematic manner. Considering that there were similar calls from academics and practitioners alike, the author thought it fit to survey some of the most influential proposals on this issue.

More recently, the EU has taken a rather non-binding soft law approach by issuing the Model Common terms of Reference in all debt instruments within the EU, which will have CAC with aggregating features. Although this is certainly a step up from the situation before, the paper has addressed the reasons as to how this is insufficient. After a thorough examination of the several debt structuring cases involving sovereigns, the author considers collective action problems and stop gap funding as core issues. Building on the above analysis, the author finally proposes the creation of a permanent sovereign debt restructuring mechanism under

⁸⁰ Carlo Panico & Francesco Purificato, 'The Role of Institutional and Political Factors in the European Debt Crisis', PERI Working Paper Series No. 280 (2012). Can be accessed [here](#).

⁸¹ The ESM Treaty and Article 136 (6) of the TFEU were challenged before the ECJ and it was decided in the favor of the Union. See *Thomas Pringle v Government of Ireland*, ECJ Case C 370/12, 2012 ECR I. Can be accessed [here](#).

EU law for the purposes of dealing with future crisis situations. The European Sovereign Debt Restructuring Framework has been envisaged to be a part of the ESM treaty itself and the mechanisms have been detailed out in the paper. The author believes that this model is consistent with the EU legal framework and would go a long way in addressing the institutional gap which currently exists. In this regard, evidences from best practices around the world have been studied and incorporated in the proposal. As a further step towards a more germane debate, the author has also provided the reader with several model treaty amendments that may be considered.

A connected question regarding the compatibility of the European Sovereign Debt Restructuring Framework with existing or developing international practices needs to be answered. In the author's analysis, decisive EU action in the form of an institutional mechanism will only augment the legitimacy and relevancy of a SDRM type approach at the international level. Further, a EU bankruptcy law can serve as a model for future developments in this field. Due to Europe's unique constitutional position, by which MS in their affairs are intrinsically linked with each other, it provides a fertile ground to test the effectiveness of such a mechanism, with anticipatory success. The author trusts that there are great benefits to be had for both Europe and the world, from the implementation of an institutional mechanism to deal with future debt crisis.

A final concern with respect to not only the specific proposal outlined above, but connected to the idea of Sovereign debt restructuring in general, is the argument of an indirect expropriation of property and its compatibility with Art. 1 of the Additional Protocol to the European Convention on Human Rights. Although the author considers that the instant paper does not occasion an elaborate discussion on such claims, suffice it to say that loss of property in any restructuring deal is inevitable. Further, since the ESDRF is to be activated only under extreme circumstances, in the backdrop of debt unsustainability of a MS, the harm induced would be sufficiently reduced and in any event authors have suggested that in all likelihood, a claim for indirect expropriation would not sustain.⁸²

⁸² See *Boudreau*, *supra* Note 30.

F. PROPOSED MODEL TREATY AMEDNMENTS

The ESM treaty will be amended so as to divide it into two parts. Part I to be titled “*Financial Stability Support under the ESM*” and would contain all the articles as presently found in the Treaty, except for Chapter 8 dealing with “Final Provisions”. Part II of the treaty will be titled “European Sovereign Debt Restructuring Framework” and will contain the following operative clauses.

CHAPTER 8

ACTIVATION OF THE ESDRF & ITS CONSEQUENCES

Article 44

Determination of Debt Unsustainability

1. Once a MS has addressed a request for stability support in accordance with Article 13 (1) of the Treaty and the European Commission (‘EC’) along with the European Central Bank (‘ECB’) has come to the conclusion that the public debt of the MS concerned is unsustainable, it shall forthwith submit a report to the Board of Governors (‘BOG’) and forward a copy of the same to the Managing Director (‘MD’).
2. The BOG upon receiving such report shall either approve such assessment or shall send it back to the EC and ECB with its comments. If however, the EC along with the ECB sends a similar report to the BOG for the second time, the BOG shall approve it.
3. The ESDRF shall be deemed to have been activated on the date of approval of the report.
4. The activation of ESDRF shall not be considered to be a ‘credit event’ for the purposes of any derivative contract.

- *Determination of Debt unsustainability by the EC & ECB.*
- *Activation of the ESDRF – not a ‘credit event’*

Article 45

Consequences of Activation of ESDRF

Upon the activation of the ESDRF, and once the ESDRC has been constituted, the following consequences shall follow:

1. An immediate and unconditional moratorium on all outstanding payments to the affected creditors , AND
2. The assets of the Sovereign Debtor shall be immune from any proceedings related to or in connection with either attachment or enforcement for the non-fulfillment of its debt obligations, in the courts of the MS.
3. A creditor may apply to the ESDRC for withdrawal of the immunity granted to the sovereign debtor.

- *Moratorium on all outstanding payments.*
- *Immunity from enforcement or attachment of assets.*

CHAPTER 9

CONSTITUTION OF THE ESDRC, ITS POWERS & FUNCTIONS

Article 46

Constitution of the ESDRC

1. Each contracting party to the present treaty shall appoint one person, with a high level of expertise and experience in Sovereign Debt Restructurings, to a reserve pool of arbitrators.
2. Upon the activation of the ESDRF, the MD in consultation with the EC and the ECB shall appoint a panel of three arbitrators from amongst the pool of arbitrators as reserved under Article 46 (1).
3. The panel of Arbitrators in determining its own rules of procedure shall be guided by the UNIDRIOT Principles of Transnational Civil Procedure.
4. The BOG shall have powers to promulgate by-laws for the purposes of the constitution of the ESDRC.

- *Dispute resolution panel (ESDRC) will be governed by the UNIDROIT Principles of Transnational Civil Procedure.*

Article 47

Powers & Functions of the ESDRC

1. The ESDRC shall have exclusive jurisdiction to hear all disputes between creditors inter se and between creditors and the sovereign debtor.
2. Without prejudice to the generality of Article 46 (1), the ESDRC shall have exclusive jurisdiction to hear disputes specifically relating to the amount of the claims involved, the aggregate voting process for the adoption of a restructuring plan and questions as regards the proper representation of the creditors in the creditor committee.
3. Notwithstanding the above provisions, questions relating to correctness or appropriateness of the debt sustainability analysis shall not be entertained by the ESDRC.
4. The decision of the ESDRC shall be final and binding.

- *ESDRC will have exclusive jurisdiction to entertain debtor-creditor disputes.*
- *ESDRC decision is final and binding.*

CHAPTER 10

DISCLOSURE, CREDITOR COMMITTEE & VOTING THRESHOLD

Article 48

Disclosure of Indebtedness

1. Upon the activation of the ESDRF, the sovereign debtor shall be obliged to disclose all information with respect to its indebtedness to its all creditors.
2. It shall place its proposal for a possible debt restructuring plan before the creditor committee as constituted under Article 49 for further negotiations.
- 3.

Article 49

Constitution of Creditor Committee

1. Upon relevant disclosures by the sovereign debtor, a committee representing the affected creditors shall be constituted based on proportional representation.
2. The committee shall not comprise of more than ten representatives.

3. The committee shall, in good faith, undertake negotiations with the sovereign debtor, so as to arrive at a restructuring plan.
4. Any dispute in relation to adequate representation of the affected creditors shall be referred to the ESDRC whose decision will be final and binding.
5. The President of the ECB and the Director General, Economic and Financial Affairs, of the EC, or their respective nominees, shall have the right to attend the meetings of the creditor committee, but shall not have the right to vote.

- *Creditor committee (max 10) to be constituted based on proportional representation.*
- *Disputes regarding adequate representation will be decided by ESDRC.*
- *ECB president & DG, Economic & Financial Affairs, right to attend meetings but not right to vote.*

Article 50

Voting Procedure

1. The voting procedure as envisaged under the ESDRF shall be on an aggregated basis.
2. The amendment of a single series of bonds shall be deemed to have been approved with the consent of creditors representing 75% of the total principle amount of the outstanding debt.
3. A cross series restructuring plan, involving different classes and series of bonds, shall be deemed to have been approved if, creditors representing 75% of the total principle amount of the debt outstanding along with creditors representing 66% of the votes in each individual series, votes in favour of the plan.

- *Cross series voting – 75% of total amount across all instruments + 66% of total amount in each instrument.*

CHAPTER 11

CONFIRMATION, IMMEDIATE FINANCING AND TERMINATION

Article 51

Confirmation of the Restructuring Plan

1. Upon the approval of the restructuring plan, it shall be send forthwith to the MD, BOG, EC, ECB, and the ESDRC for their opinion.
2. Within 20 days from the receipt of such report, the ECB, EC and the IMF shall submit its opinion to the MD and BOG.
3. Upon receipt of the report, the ESDRC shall verify the report as to its voting threshold and send its opinion to the MD and BOG.
4. The MD and BOG after a careful perusal of the report and after taking into consideration all relevant factors shall either confirm or reject the report. The BOG shall forthwith send the report along with its comments to the creditor committee for fresh negotiations, in the event of rejection of the report.

- MD and the Board of Governors to either confirm or reject the restructuring plan, as approved by the creditors.

IMF

- ESM to provide for stop gap funding and shall enjoy primary status.

Article 52

Immediate Financing Support

1. On the confirmation of the report, the BOG and MD shall entrust the EC along with the ECB, to draw out a suitable financing plan for the debtor, taking into consideration the amount necessary to support essential governmental functions and services.
2. The immediate financing support extended by the ESM shall enjoy priority status over and above all other creditor claims, except as regards any financing advanced by IMF.
3. The BOG shall approve the financial assistance detailing the aspect of the support.

Article 53

Termination

Upon the confirmation of the restructuring report by the MD and BOG, the ESDRC panel shall dissolved and become functus officio.

Article 54

Overriding Effect of Part II of the ESM Treaty

All debt contracts between MS and its creditors shall be subject to the provisions of Part II of the treaty, irrespective of whether they were entered into before or after the enactment of this part.

- *Overriding effect of the ESM Treaty.*

G. Bibliography

(EFC) Sub-Committee on EU Sovereign Debt Markets, Common terms of Reference, February 17th 2012. Can be accessed [here](#).

‘Co-ordinated Public Debt Issuance in the Euro Area’, Report of the Giovannini Group, November 8th 2000, [here](#). , *Jean-Claude Juncker & Giulio Tremonti*, ‘E-bonds would end the crisis’ Financial Times, December 5th 2010, [here](#).

‘Fitch downgrades Greek debt to BBB-minus,’ The Independent, May 20th 2010. Can be accessed [here](#).

‘Greece: Fourth Review Under the Stand-By Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria,’ IMF Country Report No. 11/175 (2011). Can be accessed [here](#).

‘Has ‘Europe’ Failed?,’ The New York Times, August 26th 2012, [here](#).

‘Is this really the end?’, The Economist, Nov 26th 2011, [here](#).

‘The Debt Crisis and the European Central Bank’s Role of Lender of Last Resort’, (PERI Working Paper Series, No. 306. (January, 2013)). Can be accessed [here](#).

‘The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations’, Prepared by the Legal and Policy Development and Review Departments, IMF, November 27th 2002. Can be accessed [here](#).

‘The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations’, IMF working paper, November 27th 2002. p. 39. Can be accessed [here](#).

‘The euro's inevitable failure will be horrendous for all of us,’ The Telegraph, May 20th 2014, [here](#).

‘The Failure of the Euro,’ Foreign Affairs, January-February 2012, [here](#).

“Moody's downgrades Greece to Ba1 from A3”, Global Credit Research, 14 Jun 2010. Can be accessed [here](#).

A Trotsenburg and A MacArthur, ‘The HIPC Initiative: Delivering Debt Relief to Poor Countries’ (IMF World Bank Washington DC 1999). Can be accessed [here](#).

A. Petrovic & R. Tutsch, ‘National Rescue Measures in Response to the Current Financial Crisis,’ (European Central Bank Legal Working Paper Series No. 8, July 2009). Can be accessed [here](#).

A. Weber, Jens Ulbrich & Karsten Wendorff, ‘Safeguarding financial market stability, strengthening investor responsibility, protecting taxpayers: A proposal to reinforce the European Stability Mechanism through supplementary bond issuance terms’, *Frankfurter Allgemeine Zeitung*, March 3rd 2011. Can be accessed [here](#).

Adrian Blundell-Wignall & Patrick Slovik, ‘A Market Perspective on the European Sovereign Debt and Banking Crisis,’ (OECD Journal: Financial Market Trends Volume 2010 – Issue 2). Can be accessed [here](#).

Adrian Blundell-Wignall & Patrick Slovik, ‘Solving the Financial and Sovereign Debt Crisis in Europe,’ (OECD Journal: Financial Market Trends Volume 2011 – Issue 2). Can be accessed [here](#).

Alexander Popov & Neeltje Van Horen, ‘The impact of sovereign debt exposure on bank lending: Evidence from the European debt crisis’, DNB Working Paper No.382 / June 2013. Can be accessed [here](#).

Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985).
Elliott Associates v. Banco de la Nacion, 194 F.3d 363 (2d Cir. 1999).

Anne Krueger, ‘International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring’, American Enterprise Institute, Washington DC, November 26th 2001. Can be accessed [here](#).

Anthony Richards & Mark Gugiatti, ‘Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets’, 6 INT’LFIN. p. 415 (2003).

Art. 123, TFEU. *Carlo Panico & Francesco Purificato*,

Art. 125, Treaty on the Functioning of European Union.

Ashoka Mody, 'Sovereign Debt and its Restructuring Framework in the Euro Area', Bruegel Working Paper No 05 (2013). Can be accessed [here](#).

Barry Eichengreen & Ashoka Mody, 'Do Collective Action Clauses Raise Borrowing Costs?', 114 ECON. J. p. 247 (2004).

Carlo Panico & Francesco Purificato, 'The Role of Institutional and Political Factors in the European Debt Crisis', PERI Working Paper Series No. 280 (2012). Can be accessed [here](#).

Charles Forelle & Stephen Fidler, 'Europe's Original Sin: National Leaders Ignored Greece's Soaring Debt for Years', WALLST. J., Mar. 3, 2010.

Daniel Gros and Thomas Mayer, 'How to deal with sovereign default in Europe: Create the European Monetary Fund now!', CEPS policy Brief No. 202, February 2010, updated May 17th 2010. Can be accessed [here](#).

David A. Skeel, Jr. & Patric Bolton, 'Inside the Black Box: How Should a sovereign Bankruptcy Framework be Structured', Emory Law Journal, Vol. 53. p. 764 (2004).

De Grauwe, 'Fighting the wrong enemy', VOX, 19th May 2010. Can be accessed [here](#).

'ECB warns against private role in bail-outs', Financial Times, 13th October, [here](#).

Fernando M. Martin & Christopher J. Waller, 'Sovereign Debt: A Modern Greek Tragedy', Federal Reserve Bank of St. Louis Review (September/October 2012). p. 321. Can be accessed [here](#).

Finn E. Kydland & Edward C. Prescott, 'Rules Rather Than Discretion: The Inconsistency of Optimal Plans', 85 J. POL. ECON. 473, 486–87 (1977). Can be accessed [here](#).

Francois Gianviti, Anne o. Krueger, Jean Pisani-Ferry, Andre Sapir & Jurgen Von Hagen, 'A European mechanism for sovereign debt crisis resolution: a proposal,' (Bruegel Blueprint Series, Vol. 10, 2010). Can be accessed [here](#).

Giancarlo Corsetti and Harold James, 'Why Europe needs its own IMF', *Financial times*, March 8th 2010., [here](#). Miguel Boyer, 'Europe needs its own IMF', *The Guardian*, March 29th 2011. Can be accessed [here](#).

Gianviti F 'The International Monetary Fund and External Debt' (1989) 215 RdC.205. p.86.

Guillermo Calvo, 'On the Time Consistency of Optimal Policy in a Monetary Economy', 46 *ECONOMETRICA* 1411 (1978).

Hal S. Scott, 'A Bankruptcy Procedure for Sovereign Debtors?', 37 *INT'LL.* 103, 108–09 (2003). Can be accessed [here](#).

IIF, 'IIF Financing Offer', July 21st 2011. Can be accessed [here](#).

IMF, 'Greece: Debt Sustainability Analysis', October 21st 2011. Can be accessed [here](#).

International Law Association (ed), *Report of the 63rd Conference* (Warsaw 1988) (International Law Association London 1988).

Jean-Victor Louis, 'Guest Editorial: The no-bailout clause and rescue packages' (2010) 47 *Common Market Law Review*, Issue 4, pp. 971–986. Can be accessed [here](#).

Jeromin Zettelmeyer, Christoph Trebesch, & Mitu Gulati, 'The Greek Debt Restructuring: An Autopsy', (PIIE Working Paper series, WP 13 – 8 (August 2013)). Can be accessed [here](#).

Joanna Dreger, 'Why Is Sovereign Debt Restructuring a Challenge? The Case of Greece', *Bruges European Economic Policy Briefings* No. 24 (2012). Can be accessed [here](#).

John C. Coffee, Jr. & William A. Klein, 'Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations', 58 *U. CHI. L. REV.* 1207, 1223 (1991).

Jörn Axel Kämmerer, 'State Bankruptcy', *Max Planck Encyclopaedia of Public International Law [MPEPIL]* (2009). Can be accessed [here](#).

José Luis Malo de Molina, 'The European Central bank's Response to the Crisis', *Economic Bulletin* (July, 2013). p. 37. Can be accessed [here](#).

K Rogoff & J Zettelmeyer, 'Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001' (2002) IMF Staff Papers No. 49, p.470. Can be accessed [here](#).

K Rogoff & J Zettelmeyer, *Supra* Note 5. See also Barnett, Barry C., *Sergio J. Galvis*, & *Ghislain Gouraige, Jr.*, 'On Third World Debt,' *Harvard International Law Journal*, Vol. 25 (1984), p. 83–151.

Kirsten H. Heppke-Falk & Guntram B. Wolff, 'Moral hazard and bail-out in fiscal federations: evidence for the German Länder', (Deutsche Bundesbank, Discussion Paper Series 1: Economic Studies No. 7, 2007). Can be accessed [here](#).

Landon Thomas Jr, 'European Banks Face Huge Losses from Greek Bonds', *New York Times*, October 4th 2011. Can be accessed [here](#).

Lee C. Buchheit & G. Mitu Gulati, 'Exit Consents in Sovereign Bond Exchanges', 48 *UCLA L. REV.* 59, 60 n.2 (2000).

Lorenzo Bini Smaghi, 'Challenges for the Euro Area, and the World Economy', Group of the Thirty, Rabat, 28 May 2010. Can be accessed [here](#).

Louise Story, Landon Thomas, Jr. & Nelson D. Schwartz, 'Wall St. Helped to Mask Debt Fueling Europe's Crisis', *N.Y. TIMES*, Feb. 14, 2010.

Lucas Papademos, 'The role of the ECB in financial crisis management' (conference on The cost of the financial crisis: Planning an exit strategy, organised by the Bank of Greece and the Hellenic Observatory at the London School of Economics and Political Science Athens, 27 May 2009). Can be accessed [here](#).

M. Reinhart Carmen & S. Rogoff Kenneth, 'Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten', IMF Working Paper, WP/13/266 (December, 2013). Can be accessed [here](#).

Mario Monti, 'A new strategy for the single market', Mario Monti Report, May 9th 2010. Can be accessed [here](#).

Mark Gugiatti & Anthony Richards, 'The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers', 35 GEO. J. INT'LL. 815, 815–17 (2004).

Mark L. J. Wright, 'Restructuring Sovereign Debts with Private Sector Creditors: Theory and Practice', University of California, Los Angeles, and National Bureau of Economic Research. June 2nd 2010. Can be accessed [here](#).

Mark L. J. Wright, 'Sovereign Debt Restructuring: Problems and Prospects', Harvard Business Law Review, Vol. 2. p. 154 (2012). Can be accessed [here](#).

Melissa A. Boudreau, 'Restructuring Sovereign Debt Under Local Law: Are Retrofit Collective Action Clauses Expropriatory?' Harvard Business Law Review online. Can be accessed [here](#).

Michael Bradley & Mitu Gulati, 'Collective Action Clauses for the Eurozone: An Empirical Analysis', third draft, May 7th 2012. Can be accessed [here](#).

Michael P. Dooley, 'International Financial Architecture and Strategic Default: Can Output Losses Following International Financial Crises be Avoided?', 53 CARNEGIE-ROCHESTERCONF. SERIES ONPUB. POL'Y361, 371–74 (2000).

Miller Marcus, 'Sovereign Debt Restructuring: New Articles, New Contracts—or No Change?', International Economics Policy Brief No. PB02-3 (2002). Can be accessed [here](#).

Nouriel Roubini & Brad Setser, 'The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode', Draft, April 2004. Can be accessed [here](#).

Patrick Bolton & David A. Skeel, JR., 'Redesigning the International Lender of Last Resort', 6 CHI. J. INT'LL. 177, 186–87 (2005).

Paul De Grauwe, 'Only a more active ECB can solve the euro crisis', CEPS Policy Brief, No. 250 (August 2011). Can be accessed [here](#).

Press Release, Ministry of Finance, Hellenic Republic, April 25th 2012. Can be accessed [here](#).

Press Release, STATEMENT BY EURO GROUP (Brussels, November 28th, 2010, [here](#). European Council Conclusion, EUCO 10/1/11 REV 1, Brussels April 20th 2011. p, 31. Can be accessed [here](#).

Press Release, STATEMENT BY THE HEADS OF STATE AND GOVERNMENT OF THE EURO AREA, (Brussels, March 25th 2010). Can be accessed [here](#).

Protocol (No. 12) on the Excessive Deficit Procedure, TFEU.

Régis Breton, Caroline Pinto & Pierre-François Weber, 'Banks, moral hazard, and public debts' (Financial Stability Review No. 16, April 2012). Can be accessed [here](#).

Roberto A. De Santis, 'The Euro Area Sovereign Debt Crisis, Safe Heaven, Credit Rating Agencies and the Spread of the Fever from Greece, Ireland and Portugal', ECB Working Paper Series, No. 1490/ February, 2012. Can be accessed [here](#).

Rogoff, K. & J. Zettelmeyer, 'Early Ideas on Sovereign Bankruptcy Reorganization: A Survey', IMF Working Paper 02/57 (2000). Can be accessed [here](#).

Silvia Ardagna and Francesco Caselli, 'The Political Economy of the Greek Debt Crisis: A Tale of Two Bailouts', Centre for Economic Performance Special Paper No. 25, LSC (2012), p. 9-10. Can be accessed [here](#).

'Sovereign Debt Restructurings – Recent Developments and Implications for the Funds Legal and Policy Framework', IMF 26th April, 2013. Can be accessed [here](#).

Stephen J. Choi, Mitu Gulati, and Eric A. Posner, 'The Evolution of Contractual Terms in Sovereign Bonds', Journal of Legal Analysis, (2012): Vol. 4, No. 1.p 133.

Steven L. Schwarcz, "'Idiot's Guide" To Sovereign Debt Restructuring', Emory Law Journal, Vol. 53. p. 1190 (2004). Can be accessed [here](#).

Steven L. Schwarcz, 'Sovereign Debt Restructuring Options: An Analytical Comparison', Harvard Business Law review, Vol. 2.p. 96. (2012). Can be accessed [here](#).

Sylvester Eijffinger & Lex Hoogduin, 'The ECB in (the) crisis', DSF Policy Paper Series, No. 22 (June 2012). Can be accessed [here](#).

Thomas Pringle v Government of Ireland, ECJ Case C 370/12, 2012 ECR I. Can be accessed [here](#).

Torbjorn Becker, Anthony Richards & Yunyong Thaicharoen, 'Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?', 61 J. INT'LECON, p. 127 (2003).

Treaty Establishing the European Stability Mechanism of 2nd February 2012, consolidated version available [here](#).

UK House of Lords European Union Committee, The Euro Area Crisis (25th Report of Session 2010-2012), ¶111. Can be accessed [here](#).

Victor Constancio, 'Contagion and the European debt crisis,' Banque de France (Financial Stability Review No. 16, April 2012). Can be accessed [here](#).

W. Mark C. Weidemaier & Mitu Gulati, 'A People's History of Collective Action Clauses', Virginia Journal of International Law, Vol. 54:1, p. 52. Can be accessed [here](#).

Zandstra Deborah, 'The European sovereign debt crisis and its evolving resolution', Capital Markets Law Journal, Vol. 6, No. 3. p 285. Can be accessed [here](#).